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## Global Economic Crisis, Long-term Growth and Policy Implications for Africa

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### The Crisis and Africa's Growth Prospects

The 2009 African Economic Conference (AEO) has discussed, in some detail, the possible impact of the current global economic crisis on African economies. It has mainly focused on the medium-term effects. The adverse impact that the crisis can have on growth in the immediate future and its effect on macroeconomic balances and fiscal space, are also well recognised. However, for some countries, the possibility that the shock could have long-lasting effect on growth has received less attention. There is considerable diversity among African countries in terms of their vulnerability to the current crisis and their potential to recover from it.

Over the past decades, sustaining growth in Africa has been much harder than achieving high growth rates. Growth in the continent has been largely volatile. There have been episodes of accelerated growth, followed invariably by deceleration. This has led to asymmetric impact on development outcomes.

Vulnerability to shocks explain much of the growth volatility documented in African economies. During growth deceleration, some of the fundamentals of the economy, such as quality of institutions, flow of foreign direct investment, savings, and human capital are significantly eroded with long-term consequences on growth. Thus, such losses could lead to a different growth trajectory in the post-recovery period, possibly causing permanent damage to a country's future development.

### The Crisis and the Threat of Drawn-out Recovery

This argument can be summarised better by the help of the well-known Solow-Swan neo-classical model of economic growth, where output per worker ( $Y$ ) is a function of capital per worker ( $K$ ) (Figure 1)<sup>1</sup>. For given population growth

rate ( $n$ ) and depreciation of capital ( $d$ ), an economy can achieve steady state or long-term equilibrium at the point of intersection between the investment line and the saving line. A resilient economy would normally remain on one



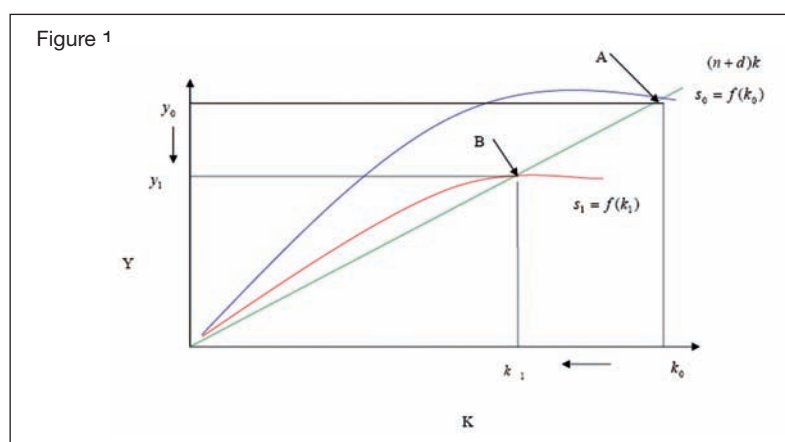
<sup>1</sup> Note also that in the context of the framework recently introduced by Hausmann et al. (2005) on determinants of growth, one can envision a situation where exogenous shocks faced by low income open economies may undermine returns to factors of production (e.g. labour and capital) and/or increase the cost of capital for firms due to financing, especially when foreign borrowing is a binding constraint for investment.

particular curve due to capacity to sustain the drivers of growth in the wake of shocks. Thus, the impact of exogenous shocks would only lead to temporary declines in per capita incomes, as the economy is able to bounce back to the equilibrium in pre-crisis period. On the other hand, short-lived shock could permanently affect the fundamentals of the economy, such that there is a shift from pre-crisis equilibrium (A) to a new post-crisis equilibrium (B). In this case, long term per capita income could be lower in the post-crisis period. This is illustrated by a decline from  $y_0$  to  $y_1$ .

Episodes of growth deceleration commonly caused by internal or external shocks would thus lead to a decline in the performance of economic and po-

litical institutions, human capital, and other key growth fundamentals, such as savings and investment. Household level evidence on the persistence of shocks in Africa also supports the same argument. Current income shocks in-

duced by unemployment or crop failures could lead to a lower long-term income in an environment of limited risk-sharing and income protection arrangements<sup>2</sup>. The same can be said about countries.



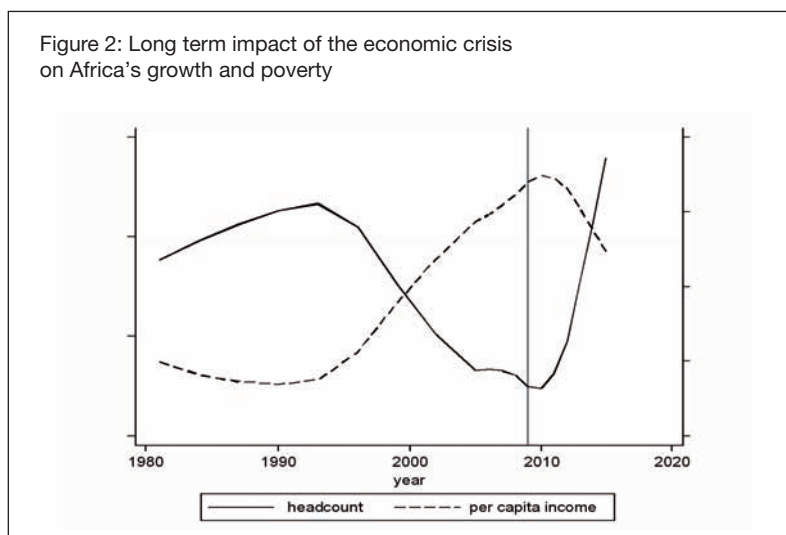
## The Crisis and Poverty

In the absence of significant risk-mitigating responses, such as emergency loans, increased foreign aid, and other support mechanisms, the current crisis can degenerate into a development crisis. We provide in figures 2, 3, and 4, possible paths of growth and poverty-based on assumptions about long-term consequences of the current crisis for countries classified on the basis of their performance in reducing poverty in the last two decades. Figure 2 refers to a typical African economy. It captures the effects of the crisis on long-term growth and poverty. As argued above, if recovery comes slowly and as a consequence key drivers of growth are compromised, long term per capita income falls, leading to an increase in the level of absolute poverty. The steady growth experienced since 2000 has led to substantial decline in absolute poverty in Africa as shown in Figure 2. The development has partly been assisted by declining income inequality. Between 2000 and

2005, for instance, average poverty for Africa declined from 52 percent to 46 percent. This recorded the sharpest ever decline experienced in more than two decades.

However, if the current crisis persists, it could lead to a sharp increase in po-

verty by 2015, the target year for the attainment of the MDGs. The figure could even be much higher if we adjust for the fact that during economic crisis, income inequality generally worsens, particularly in light of the pervading effects of food and energy price crisis, which hurt the poor disproportionately.



<sup>2</sup> See for instance, Dercon (200), "Growth and Shocks: Evidence from Rural Ethiopia", Journal of Development Economics, vol 74, issue 2, Pages 309-329, Bigsten and Shimeles (2008), "Poverty Transition and Persistence in Ethiopia:1994-2004" World Development, vol. 36(9), pages 1559-1584, Islam and Shimeles (2007), "Working Papers in Economics 260, Göteborg University, Department of Economics.

Figure 3 highlights the trend for best performing economies during the past two decades. These countries have managed to reduce the headcount ratio dramatically from 21 percent to just seven percent by growing fast as well as containing inequality on its track. The current crisis could stall the pace of poverty reduction in these countries.

Figure 4 illustrates the scenario of the current crisis in highly vulnerable and low performing countries in the last two decades. These countries generally saw a phenomenal increase in poverty from just 20 percent to 45 percent in the last two decades, mainly because of stagnation, declining per capita income, and rising inequality. The current crisis could further worsen the wellbeing of people in these countries. Understandably, the initial condition and the performance in the last decade could play a very important role in designing policy responses.

## Policy Implications: How to Allocate Aid

In summary, the possibility that the current global crisis could lead to permanent or long-lasting effects on some African economies has profound impact on the nature of policy response. The current global crisis has raised a policy dilemma on how best to allocate Official Development Assistance (ODA). Should more aid be given to countries that have been hit hard by the crisis but have the potential to quickly recover, or to those that are weak and vulnerable with little chance of quick recovery? Ri-

sing commodity prices, especially that of oil, coffee and minerals in recent months has made the above policy question even more complicated. It follows from this note that the policy responses by donors need to be coordinated along the lines of both short-term and long-term views of the impact of the crisis on different African economies.

With swift and effective response, some low income countries (LICs) can

continue to grow and the majority can avert a developmental crisis. Support to middle income countries (MICS) and high performers before the crisis can sustain regional growth engines. Further deterioration of economic performance in these countries will have negative spill-over effects on neighbouring LICs, and cause delayed recovery. Speedy and scaled up new financing for Africa is critical for putting the continent on the development path and also to help in global recovery.

Figure 3: Long term impact of the economic crisis on growth and poverty in the best performing economies<sup>3</sup>

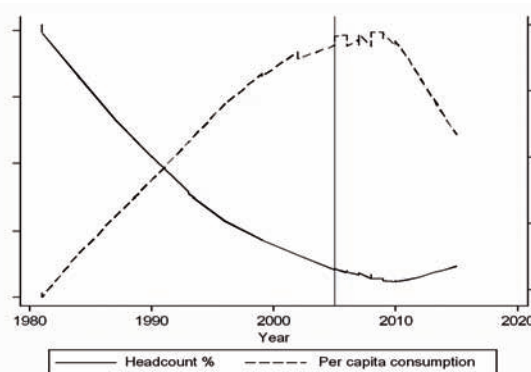
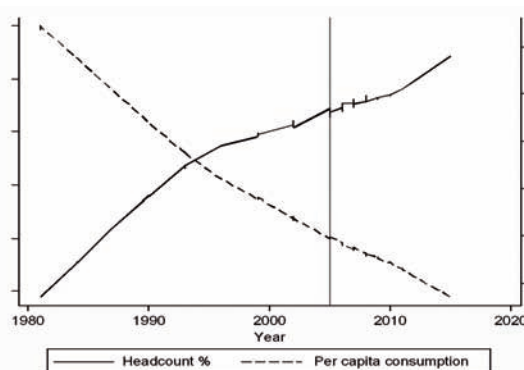


Figure 4: Long term impact of the economic crisis on growth and poverty in the worst performing countries<sup>4</sup>



<sup>3</sup> These countries are Egypt, Tunisia, and Morocco.

<sup>4</sup> These countries include Cote d'Ivoire, Djibouti, Equatorial Guinea, Gabon, DRC, and Nigeria.

Comments and suggestions can be sent to:

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